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SIPDIS

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SUBJECT: A POSSIBLE WAY OUT OF THE FUEL CRISIS

REF: COLOMBO 186

1. (SBU) SUMMARY: ON JUNE 11, THE GOVERNMENT OF SRI LANKA (GSL) RAISED THE PRICE OF FUEL FOR THE SECOND TIME IN EIGHT WEEKS AND ANNOUNCED PLANS TO LIBERALIZE FUEL PRICES. THE PRICE HIKE ANNOUNCEMENT CAME AS ABOUT A THIRD OF THE STATIONS IN SRI LANKA, RUN BY THE INDIAN OWNED LANKA INDIAN OIL COMPANY (LIOC), BEGAN RUNNING OUT OF GASOLINE. LIOC HAS RUN OUT OF ITS GASOLINE STOCKS AND HAS STOPPED ORDERING STOCKS BECAUSE OF A SHORTAGE OF FUNDS DUE TO THE NON-PAYMENT OF THE SUBSIDY BY THE GSL. THESE DEVELOPMENTS HAVE FORCED THE GOVERNMENT TO RE-THINK ITS CONTROL ON FUEL PRICES AND TO TAKE STEPS TO OFFER A BELATED SOLUTION TO THE LIOC. END SUMMARY.

LIOC LETS GAS STATIONS RUN DRY

2. (U) ON JUNE 9, FUEL STATIONS OPERATED BY THE LIOC CLOSED DOWN GASOLINE PUMPS DUE TO THE NON-AVAILABILITY OF GASOLINE (DIESEL PUMPS AT THE STATIONS CONTINUE TO OPERATE). PREVIOUSLY, THE LIOC REPORTED A LOSS OF RS 7.07 BILLION (APPROXIMATELY USD 70 MILLION) FOR THE FINANCIAL YEAR ENDING MARCH 31, 2006 AND WARNED THAT IT WOULD STOP BUYING FUEL. ACCORDING TO LIOC, THE GOVERNMENT OWED THE COMPANY ABOUT RS 7.4 BILLION (USD 74 MILLION) AS OF MARCH 31. REPORTEDLY, THEIR CLAIM NOW EXCEEDS RS 11 BILLION (USD 110 MILLION). PETROLEUM PRODUCTS ARE SUBSIDIZED BY THE GOVERNMENT WITH THE GOVERNMENT AGREEING TO PAY THE OIL COMPANIES THE DIFFERENCE BETWEEN THE COST AND THE SELLING PRICE, INCLUDING A 5 PERCENT PROFIT MARGIN. THE GOVERNMENT, LIOC AND THE GOVERNMENT OWNED CEYLON PETROLEUM CORPORATION (CPC) AGREED ON THIS PRICING FORMULA IN 2003 WHEN THE LIOC ENTERED THE MARKET PURCHASING OVER 100 FUEL SHEDS OWNED BY THE CPC AND A PARTIAL STAKE OF CPC'S OIL STORAGE FACILITY.

3. (U) AS LIOC RAN OUT OF GASOLINE, THE GOVERNMENT TOOK STEPS TO INCREASE FUEL PRICES. THE NEW PRICE OF GASOLINE IS RS 93 (US 93 CENTS) PER LITRE AND DIESEL RS 61 (US 61 CENTS) PER LITRE. SO FAR, THE GOVERNMENT HAS INCREASED THE PRICE OF GASOLINE BY 16 PERCENT AND DIESEL BY 22 PERCENT IN 2006. THE GOVERNMENT HAS ALSO RAISED THE PRICE OF KEROSENE, MOSTLY USED BY LOW INCOME HOUSEHOLDS FOR COOKING. THESE PRICES ALSO INCLUDE VARIOUS TAXES IMPOSED BY THE GOVERNMENT.

GSL MAY PARTIALLY PAY ITS SUBSIDY OBLIGATIONS TO LIOC

4. (SBU) MR. S. ATTYGALLE, DIRECTOR GENERAL OF FISCAL POLICY, TOLD ECONFSN ON JUNE 15 THAT THE CABINET HAS AGREED TO PAY THE SUBSIDIES DUE TO LIOC UP TO JUNE 30, 2006 AND THEREAFTER ALLOW THE COMPANY TO DECIDE THE SELLING PRICE. THE CABINET HAS APPROVED THE PAYMENT OF RS 1 BILLION (USD 10

MILLION) IN CASH WITH THE BALANCE IN 2 YEAR INTEREST-BEARING TREASURY INSTRUMENTS. WHILE, THE LIOC'S FULL CLAIM WILL NOT BE KNOWN UNTIL JUNE 30, THE GOVERNMENT IS UNLIKELY TO HONOR THE ENTIRE CLAIM WHICH IS BASED ON A 5 PERCENT PROFIT MARGIN AS AGREED IN THE PRIVATIZATION AGREEMENT. ACCORDING TO ATTYGALLE, THE GOVERNMENT HAS AGREED TO ALLOW LIOC A PROFIT MARGIN OF 1.5 PERCENT INSTEAD OF THE 5 PERCENT MARGIN. THIS MOVE SHOULD ENABLE THE GOVERNMENT TO AVOID ABOUT RS 2.5 BILLION (USD 25 MILLION) OF ITS CONTRACTUAL OBLIGATION TO LIOC BY RENEGING ON THE AGREEMENT SIGNED WITH THE INDIAN OIL CORPORATION (IOC).

POSSIBLE FUEL PRICE LIBERALIZATION ON JULY 1 FOR LIOC

15. (SBU) ACCORDING TO ATTYGALLE, THE GOVERNMENT HAS ALSO PROPOSED TO LIBERALIZE FUEL PRICES AND ALLOW LIOC TO DETERMINE THE SELLING PRICES OF FUEL STARTING ON JULY 1. CONSEQUENTLY, THE GOVERNMENT WILL NOT PROVIDE A SUBSIDY TO LIOC. IT IS STILL NOT CLEAR HOW THE GOVERNMENT OWNED CEYLON PETROLEUM CORPORATION (CPC) WILL DETERMINE ITS PRICES IF AND WHEN PRICES ARE LIBERALIZED. IT IS MOST LIKELY THAT THE GOVERNMENT WILL SET THE PRICE OF FUEL SOLD BY THE CPC AND PAY A SUBSIDY TO CPC IF CPC'S COSTS ARE HIGHER THAN ITS PERMITTED SALES PRICE. ACCORDING TO ATTYGALLE, LIOC HAS NOT YET COMMUNICATED ACCEPTANCE OF THE GOVERNMENT'S PROPOSAL. LIOC'S MANAGING DIRECTOR, MR K. RAMAKRISHNAN IS IN INDIA DISCUSSING THE GOVERNMENT PROPOSAL WITH THE PARENT COMPANY IOC. NEITHER THE LIOC NOR THE GOVERNMENT HAS RELEASED AN OFFICIAL STATEMENT REGARDING THE AGREEMENT.

16. (SBU) COMMENT: THE DEBT TO LIOC IS ONE EXAMPLE OF VARIOUS DELAYED PAYMENTS FACING THE INCREASINGLY CASH-STRAPPED GSL AS IT ATTEMPTS TO AVOID ELIMINATING EXPENSIVE

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SUBSIDIES FOR FUEL, ELECTRICITY, AND OTHER RESOURCES AND SERVICES. LIOC IS THE FIRST COMPANY TO TAKE THE DRASTIC MEASURE OF CLOSING ITS FACILITIES, A MOVE THAT HAD TO OCCUR SOMETIME IN ORDER TO CUT LOSSES. IT IS NOT YET KNOWN IF THE LIOC WOULD ACCEPT THE GOVERNMENT'S PROPOSED DEAL. IT IS HOPED THAT THE LIOC WILL BE PERMITTED TO FIX FUEL PRICES IN LINE WITH WORLD OIL PRICES, AND THAT THE GSL-OWNED STATIONS WILL BE PERMITTED TO FOLLOW SUIT. MOVING FUEL PRICES TO A TRUER MARKET RATE WILL FREE GOVERNMENT FUNDS TO PAY FOR MORE ESSENTIAL GOVERNMENT SERVICES AND AVOID SIMILAR SITUATIONS AND FUTURE LOSSES AT OIL COMPANIES. HOWEVER, SHARP FUEL PRICE HIKES WILL BE POLITICALLY DIFFICULT FOR THE GOVERNMENT WHICH CAME TO POWER ON A PRO-POOR PLATFORM. IN PARTICULAR, DIESEL AND KEROSENE, MOSTLY USED BY LOW INCOME GROUPS ENJOY HIGHER SUBSIDIES AND THEIR PRICES WILL HAVE TO BE MOVED SHARPLY UPWARDS TO REFLECT WORLD PRICES. THEREFORE, IT REMAINS TO BE SEEN IF THE GOVERNMENT WILL MOVE AHEAD WITH THESE DIFFICULT REFORMS. END COMMENT.

LUNSTEAD